# Real Estate Newsletter

**Welcome to the summer edition of our Real Estate Newsletter, which will cover hot topics in the world of real estate and real estate financing.**

**The guest article of the international insurance broker and M&A adviser Willis GmbH & Co. KG focuses on the topic "Warranty & Indemnity" insurance as a transaction specific insurance solution. The W&I insurance generates significant added value to the M&A practice. It facilitates bilateral negotiations to conclude transactions successfully and offers high strategic benefits to sellers and buyers.**

**Anette Gärtner and Mathias Klement provide background information on German copyright law and its implications for building projects. The authors highlight potential issues of dispute between the architect and the principal and, against that background, stress the importance of including appropriate contractual provisions to adequately balance the interests of the parties.**

**In his chapter, Patrick Härle takes a closer look into the spirit and purpose as well as the validity of so called radius clauses in factory outlet centre leases and gives practical tips as to the drafting of such clauses.**

**We hope that you enjoy our latest edition of our Real Estate Newsletter.**

**Christian Trenkel & Gerold Jaeger**

## Warranty & Indemnity Insurance (W&I)

Warranty and indemnity insurance is becoming increasingly important in connection with company acquisitions and disposals. Although this was still a relatively unknown and insignificant insurance solution in Germany until recent years, both demand and the number of contracts concluded have risen steadily over the last three years.

When a transaction is concluded, the buyer and seller agree on guarantees that must be provided by the seller. These guarantees are set out in the purchase agreement. Examples of guarantees are the provision of capital contributions, the correctness of tax procedures or the freedom from encumbrance of shares in a business. The seller is liable to the buyer for the correctness of these contractual guarantees. If a guarantee provided by the seller is defective and this results in a breach of contract that is not recognised by the seller, the buyer must assert his or her claims against the seller arising from the guarantee in court, whereby the buyer also bears the risk of insolvency of the seller. W&I insurance protects against these kinds of risks.

W&I insurance is generally taken out before a transaction is closed. Final

offers and policy negotiations with W&I insurers require comprehensive due diligence reports to be available regarding the transaction for the areas of finance, legal, tax and environment, to enable the insurers to identify and classify the risks involved in a transaction. The entire process from the issuing of instructions by the seller/buyer to the final placement takes 10 to 15 days.

Both the buyer and the seller can take out W&I insurance in connection with a transaction. If the seller is the policyholder (seller-side policy) and is liable for a defective guarantee, he or she shall be entitled to claim indemnification from the insurer against liability claims from the buyer. The seller's rights to coverage under the policy can be transferred to the buyer, giving the buyer a direct claim against the insurer and allowing him or her to obtain compensation from the insurer for damage resulting from a defective guarantee.

If the buyer is the policyholder (buyer-side policy), he or she shall be entitled to claim compensation from the insurer for losses he or she has suffered as a result of the defective guarantee. In practice, a waiver of recourse for the insurer is usually agreed in buyer-side policies, i.e. the W&I insurer has no recourse against the seller.

The reasons for taking out W&I insurance (seller-side policy) and the **benefits for the seller** are multi-faceted and obvious:

- Arrangement of a "clean exit" and basic simplification of closing
- Reduction of the extent of risk and the risk period, for example by extending guarantee periods
- Allocation of almost all sales proceeds to the selling investor
- Elimination of the requirement for an escrow, resulting in higher interest income
- Maximisation of the value of the transaction by offering a higher guarantee

W&I insurance (buyer-side policy) also offers **clear benefits to the buyer** in a transaction:

- Additional and extended cover for guarantees against breach of contract – period and scope
- Enhancement of an offer with right to claim additional compensation from an insurer
- Increased security when entering new and unfamiliar jurisdictions and branches of industry
- Protection of relationship with the seller if the seller is to assume key functions at the target company after closing
- More attractive offer due to higher cash-out to the seller

W&I insurance has become a firmly established part of transactions in common practice, particularly as it generates liquidity and provides greater certainty in planning for both parties to the contract, but also because it dispenses with the need to establish balance sheet reserves for warranty cases.

Demand for advice from investors and private equity companies, lawyers and financial advisers is higher than ever, including in Germany.

The policy limit for W&I insurance is generally between 10% and 40% of the purchase price, with the contractually agreed retention generally amounting to 1% of the purchase price. The insurance premium, which is paid as a lump sum, ranges from 1% to 2% of the policy limit. While guarantees were more likely to be protected with escrow accounts and bank guarantees in the past, W&I insurance offers a much more efficient solution in terms of cost, as funds for any claims under guarantees do not have to be "parked" in accounts and the credit line is not reduced.

Standard exclusions that are customary in the market for W&I insurance include the following in particular:

- Knowledge of the transaction team
- Specific guarantees (known circumstances)
- Intent, fraud (this exclusion applies only in connection with a seller-side policy)
- Modifications to the SPA without the insurer's approval
- Uninsurable penalties
- Advance guarantees
- Adjustments to the purchase price
- Pension underfunding
- Retroactive changes in the law
- Changes in accounting methods
- Transfer pricing
- Hidden profit distribution
- Tax assets in connection with the company acquisition

Willis has been the first insurance broker and M&A adviser to design a legally sound, German-language insurance policy under the brand *'Willis W&I Professional'*. The respective wording pays particular attention to transactions on the basis of German-language company acquisition agreements and due diligence reports.

Irrespective of the language of the insurance contract, *'Willis W&I Professional'* is not to be understood

simply as transaction insurance, but as an efficient and transparent process that is geared towards the specific and time-related requirements of the M&A sector and takes into account the procedure for each project on a made-to-measure basis.

As well as actually structuring the W&I policy, the primary task of the insurance broker is to coordinate and actively manage the process that is necessary for this. The aim is to protect the guarantee catalogue of a purchase agreement as comprehensively as possible and at the best possible insurance premium at the time of signing/closing.

Willis takes on key tasks associated with the transaction:

- Initial assessment of the company acquisition agreement and analysis of any critical guarantees
- Project-specific identification of potential W&I insurers
- Obtaining initial quotes
- Organisation and subject-based preparation of the underwriting call
- Negotiations with insurers regarding any critical guarantees and insurance premiums
- Ensuring that the physical policy is issued on time and that the premium is calculated at the time of signing/closing
- Complete administrative management and exchange of necessary documents such as confidentiality agreements, release letters, due diligence reports, etc.

Choosing the right insurer plays an important part in ensuring that the W&I process runs smoothly. The W&I insurance market is essentially limited in terms of the number of market operators and their capacity. Reaction speed, level of premiums, flexibility with regard to languages and customer focus vary and are often very project-specific. Once again, Willis will support its W&I customers here in choosing a suitable partner.

As well as W&I insurance, there are three other insurance concepts with regard to company transactions:

- Tax indemnity insurance (protection against unexpected tax effects)
- Environmental indemnity insurance (protection against misjudgement of environmental conditions)
- Contingent risks insurance (protection against pending or imminent legal disputes and risks relating to legal interpretations)

**Willis' global M&A team** can look back on over 60 years' experience and collaboration with the largest private equity companies, law firms and financial advisers. In the M&A sector, Willis Germany has specialised in W&I insurance as well as insurance due diligence. The wording of W&I policies is now also available in German.

The following contacts at Willis in Germany will be happy to help you:

- Marc Schumacher, Member of the German Management
- Jürgen Reinschmidt, Member of the German Management
- Stephanie Wetzel, Project Manager

## Copyright law and its implications for building projects: Balancing the interests of architect and principal

**Introduction**

In the context of building projects, the architect often plays an important role – also from the legal point of view. Principals, however, sometimes do not realise that the architectural design of the building and the corresponding blueprints enjoy copyright protection just like a painting or a novel. In this respect, the architect, as the creator of the building, has a strong legal position: While the principal acquires ownership of the building, this does not affect the architect's rights under copyright law. It may therefore come as a surprise that contracts with architects often do not contain adequate IP clauses that provide for a balancing of interests.

Especially, although by no means only, in the case of high-profile building projects, which are often designed by renowned architects, disputes may later arise as a consequence of this oversight. The disputed issue is usually the principal's wish to alter the building after its completion or, in extreme cases, to have it partially or entirely demolished. Famous recent examples include the disputes regarding the ceiling construction of Berlin's central station or the partial demolition of Stuttgart's railway station building in the course of the "Stuttgart 21" project.

In order to reduce the risk of such a dispute arising, it is suggested that the parties involved attempt to find a balance at the beginning of a building project, taking account of their (often opposing) interests through meaning-

ful drafting of the contract. Care must be taken to avoid certain "pitfalls", which lead to problems especially where standard business terms and conditions are used. Not least for the buyer of a property is it therefore essential to examine the agreements between the seller and the architect with particular scrutiny.

**Copyright protection of buildings**

Under Section 1 of the German Copyright Act (*Urheberrechtsgesetz*, "**UrhG**"), works of literature, science and research, and art enjoy copyright protection. The non-exhaustive list of protected works also includes "works of architecture" (*Werke der Baukunst,* Section 2 para 1 No. 4 of the UrhG). Drafts, building plans and models can also be protected under the UrhG. However, this applies only if they constitute the "own intellectual creation" of the author (*persönliche geistige Schöpfung,* Section 2 para 2 of the UrhG). German courts have established a number of criteria to determine whether this requirement is met, among which the so-called "degree of creativity" (*Schöpfungshöhe*) is particularly important: a building qualifies for copyright protection if it "stands out from the mass of everyday building activity". An example of this was the "Astra-Turm" tower block in Hamburg, which was designed in the shape of a Pilsner beer glass. By contrast, the type of building and its intended use are irrelevant. Not only museums, theatres or churches can be protected, but also warehouses, factories and even noise abatement walls along motorways. Copyright protection may also extend to individual parts of buildings, such as facades or stairwells.

**The architect's rights under the UrhG**

German copyright has two main characteristics. First, the architect has extensive rights of exploitation and use of the work. Although copyright as such is not transferrable (Section 29 para 1 of the UrhG), third parties (*e.g.* the principal) can be granted a right to use the work and exploit it on a commercial basis, a licence. Second, the building is the result of an author's own intellectual creation. With respect to this "personality right" of the author (*"Urheberpersönlichkeitsrecht"*) and its various peculiarities, the architect has only extremely limited power to dispose of this right.

In addition, when drafting IP clauses for a building contract one must bear in mind that the rights granted under the UrhG lie with the "individual creator" of a work (*persönlicher Schöpfer,* Section 7 of the UrhG). In contrast to US law, for example, the UrhG does not recognise the principle of "work for hire", according to which the rights in the work vest in the principal. Under German law, the creator retains the copyright in his creation. Accordingly, the principal is well-advised to enquire as to who will actually provide the services under the building contract: The architect himself or one of his employees?

The main rights of exploitation in the case of buildings are the right of reproduction (replication of the building) and those of adaptation and remodelling. However, in the case of the remodelling of a building, the architect's personality rights must also be taken into account. Even if the architect is in a position to permit the principal to remodel the building, he still has the right to forbid an adaptation of the work if this might prejudice his personal interests in the work (Section 14 of the UrhG – so-called "distortion prohibition", *Entstellungsverbot*). This will be the case if the essential features of the work are distorted in course of the adaptation. This is determined by weighing the interests of the architect against those of the principal. If it is not reasonable to expect the architect to accept the measures taken, his copyright is infringed.

A copyright infringement may have far-reaching and costly consequences for principals. Apart from claiming damages, the architect may demand that the copyright infringement – e.g. the renovation measure that has already been implemented – be removed. In this context, it is irrelevant whether the principal acted wilfully or negligently. For instance, in the proceedings related to Berlin's central station, the Regional Court of Berlin ordered the principal to remove completely the flat ceiling that had already been installed, as it had distorted the work of the architect. The costs of removing the flat ceiling and of installing the originally planned vaulted ceiling were estimated at approximately EUR 45 million at the time. The building project was also to be delayed by several years. An architect can also seek a preliminary injunction ceasing the renovation measure, thus bringing building work to a halt.

In addition, the principal must deal with a series of other issues both before and after changes are implemented: for example, is the principal allowed to instruct another architect to complete the building based on the blueprints of the original architect, or even to diverge from the original design? It is also debatable to what extent it is permitted to renovate or modernise an existing building.

**Solution: contractual provisions to reflect the interests of the parties**

As outlined above, German copyright law puts the architect in a particularly strong position. Many of his rights, however, may be waived or limited by contractual provisions.

A contract with an architect should therefore include clauses addressing rights of use and adaption as well as their transferability (in particular, to future buyers of the real estate). Having said this, the inalienable personality right of the copyright owner limits the freedom to make contractual arrangements. The mandatory provisions of the UrhG may lead to the partial or even complete invalidity of the agreed clause when it is subject to scrutiny under the law on standard business terms and conditions. For example, the principal cannot demand that he be granted the right to alter the work in general and without limitation, since this would also include impermissible distortions to the work.

**Conclusion**

Buildings will often enjoy copyright protection. By reaching the appropriate agreements, it is possible to balance the partly opposing interests of the principal, who must be able to dispose of his property with as few restrictions as possible, and those of the architect, who wishes to ensure that his creation is sufficiently protected. When drafting a specific contract, however, the particular features of copyright law must be taken into account to prevent the agreed clauses from being invalid.

For this reason, buyers of property would be well advised to ensure that they obtain all necessary rights of use in terms of the UrhG before making their purchase. Costly disputes with the architect over alleged copyright infringements can thus be avoided to the extent possible.

**Your contacts:**


- Dr. Anette Gärtner, Clifford Chance
- Mathias Klement, Clifford Chance


## Legal doubts regarding the validity of "radius clauses" in lease agreements for premises in factory outlet centres

**Introduction/legal problem**

It is quite customary to include what is known as a "radius clause" in lease agreements for premises in factory outlet centres. Such clauses stipulate that the tenant, or any affiliates of the tenant, may not rent premises in similar centres, or otherwise open and operate any factory outlet stores within a certain radius (of usually between 50 and 200 km) around the factory outlet centre in which the premises to be rented are located. Quite frequently, any infringements of such clauses are made subject to a contractual penalty. Such radius clauses have the purpose of protecting factory outlet centres from local competition, of preserving their exclusiveness and, ultimately, of ensuring the financial success of investments made in such centres. Currently, a number of judicial and regulatory procedures are pending to determine whether, or to what extent, such radius clauses in lease agreements are actually legally permissible.

On the one hand, the Higher Regional Court (*Oberlandesgericht*) in Karlsruhe has confirmed the validity of an individually negotiated radius clause providing for a straight-line radius of 100 km. On the other hand, however, it remains unclear whether such clauses are also valid if contained in standard lease agreements that are generally used for premises in a given factory outlet centre and are therefore regarded as being general terms of business (*Allgemeine Geschäftsbedingungen*). The panel of the Federal Cartel Office (*Bundeskartellamt*) that has jurisdiction for this matter has instituted a procedure under section 1 of the Restraints on Competition Act (*Gesetz gegen Wettbewerbsbeschränkungen*, "**GWB**") to clarify this question from an antitrust perspective. There is also another lawsuit on this issue pending at the Regional Court (*Landgericht*) in Mannheim.

**Discussion/Comments**

Parties opposed to the use of radius clauses (and who have presumably encouraged the institution of the proceedings pending at the Federal Cartel Office) argue that any prohibition to open other outlets within a certain radius around a factory outlet centre constitutes a violation of section 1 GWB. The principal argument of these critics is that such radius clauses impede or even preclude the opening of other factory outlet centres within the area concerned.

On the other hand, those who advocate the permissibility of radius clauses claim that such clauses are needed to protect the rarefaction and thus the locational conditions required for the successful operation of such centres. Factory outlet centres can only be an attractive shopping destination if the range of goods sold there, as well as the tenant composition are adequate. While the 'market' of potential tenants is limited and

cannot be exchanged as wished, it is necessary to ensure that these tenants have sufficient potential customers. Due consideration must be given to both of these realities. This means that tenants of premises in a factory outlet centre cannot be expected to compete against other outlets located within their catchment area.

In this respect, particular consideration must be given to the special characteristics of a factory outlet centre. As a rule, the goods on offer in such centres are being put on the market directly by their manufacturer and, therefore, cannot also be sold by any given retailer or speciality retailer. Factory outlet centres therefore constitute a separate distribution channel, which is also of advantage to each individual tenant since each tenant also benefits from the presence of customers primordially attracted by other tenants and whose presence helps to increase the sales of all tenants of premises within the centre. As a rule, classical retailers are not adversely affected by this and may open shops or other points of sale within the area covered by a radius clause. Consequently, it is argued that any restraint on competition that might arise would be limited to outlet centres and that these constitute a separate distribution channel.

At present, it is still unclear as of what point fair competition is deemed to be impeded or even precluded. The Federal Cartel Office has not yet handed down any decisions setting precedents on this issue. There would be good reasons for stipulating that the area covered by a radius clause should not extend beyond the catchment area of the relevant outlet centre. It could also be argued in support of that view that a radius clause limited to the catchment area does not fall under the general ban on cartels because such a prohibition to open and operate factory outlets within that area is inherent to the lease agreement. In practice, however, it may be difficult to determine the limits of a catchment area with a sufficient degree of accuracy. It therefore remains to be seen whether the Federal Cartel Office will bring itself to fixing an across-the-board distance specification. This would bring about a considerably greater measure of legal certainty. Judging by the current state of the debate, there seems to be a considerable risk that the Federal Cartel Office may regard a radius of between 150 and 200 km, i.e. a radius not corresponding to the actual catchment area of a factory outlet centre, as being excessive, while it is unlikely that the Federal Cartel Office will object to radius clauses extending over a significantly smaller area (e.g. 5 km).

Also, it is unlikely for economic reasons, i.e. the competitive pressure that would arise, that a new factory outlet centre is built within the catchment area of an existing outlet centre. Therefore, the presence of a radius clause in lease agreements does not categorically rule out the possibility of other outlet centres being built. As a general rule, however, it can be said that the smaller the area covered by a radius clause is, and depending on whether and to what extent an outlet centre is located within the catchment area of another outlet centre, the more likely it is that a radius clause will be held to be legally effective.

Ultimately, the existence of a legally effective radius clause is in the interest of both the operator of a factory outlet centre as well as of the tenants occupying premises therein. The success of such a centre is dependent on its rarefaction and radius clauses contained in lease agreements are one means to effectuate and secure such rarefaction.

**Practical remarks**

A radius clause is a worthwhile component of lease agreements for premises in a factory outlet centre. Despite this, it is currently still possible that the Federal Cartel Office, or a senior court, hand down a ruling declaring such clauses to be legally impermissible and therefore void. Consequently, the question is what to do while such legal uncertainty remains.

Of course, dispensing with a radius clause altogether may be regarded as the most obvious solution and not involve any risk of not being legally effective but, as explained above, this would not be in the interest of either party involved, i.e. neither the tenant, nor the landlord.

To ensure the 'survivability' of a radius clause, it is necessary to ensure that it duly reflects the interests of both parties and that its wording is well balanced. One important means to achieve this is to ensure that it does not provide for a radius extending beyond the actual catchment area of the factory outlet centre. It is always preferable to err on the side of caution when making this determination. This significantly reduces the risk of the entire clause being void.

It should also be clearly stipulated that any invalidity of the radius clause will not adversely affect the validity of the lease agreement as such and that in the event of such invalidity of the radius clause the parties will negotiate a revised version of that clause in light of whatever decision may be

handed down by the Federal Cartel Office.

In view of the growing economic significance of factory outlet centres in Germany, it would be very helpful if the Federal Cartel Office were to complete its current inquiries soon.

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# Notes

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